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Audit's. MARKET ANALYSIS OF REITS AND REAL ESTATE COMPANIES

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# Realty Stock Review

February 10, 1989 (Priced Feb. 8) Volume XX, Number 3

# Mortgage Group Uncertainties Spark High Yields

## It May Be The Time To Plan For Easing Short Term Rates

Short-term interest rates show no sign of easing right now, because Federal Reserve Chrm. Alan Greenspan keeps insisting that inflation is the economy's Public Enemy No. 1. And the economy has shown no real signs of tipping into the recession many economists have been predicting for well over a year.

The Fed's stance has given us a rare inverted yield curve, in which short-term rates are higher than long-term rates. Inverted yield curves have appeared only nine times in the past 35 years — but six times they have preceded recessions. In those times short-term rates have kept climbing (for an average one year) before plunging as a recession unfolded. This reasoning is behind some common forecasts notably by Merrill Lynch — that 3-month Treasuries will be at 6.5% by Christmas — vs. 8.82% today.

So we think investors have to start planning for the day when the Fed starts easing credit, and when mortgage REITs and mortgage bankers stop being squeezed by short-term interest rates. Hence we think you have to approach the companies reviewed this issue on the basis of what is likely to happen, and when, rather than focusing on what "is" right now. On this basis, mortgage REIT and mortgage banking stocks become slightly more attractive currently, but selectivity remains the key.

Interest rate sensitive stocks are down right now because investors can collect good yields in Treasuries: 9.1% in 5-year Treasuries and 8.8% on 30-year bonds. Market prices on mortgage entities are now marked down so yields compete.

The notable exception is that old reliable money market barometer, Fannie Mae, whose stock has been soaring to new highs as Wall Street buys FNM's story that its earnings have indeed been liberated from their ties to the money market. Our review inside finds strong evidence that this indeed is the case.

The 10 stocks reviewed this issue yield anywhere from zero (**Integrated Resources** and **Wedgestone Financial**) to 14.8% (**American Realty**) and average 9.2%. Current price averages 12.6% over historic cost book value, up from a 4% premium when last we reviewed this group in May 1988. The price-to-book ratio ranges from a 113% premium over book for **Federal National Mortgage Assn. (Fannie Mae)** to a 57% discount for troubled **Wedgestone Financial**. Half sell at discounts to book value, half over (see table below).

We are raising one stock, Fannie Mae, to A Rank with this issue for reasons stated in our review. FNM management has taken charge of its asset and liability mix, has created an entirely new income stream with mortgage backed securities (MBS) guaranty fees, and has tightened underwriting to stem loan losses. It is the growth pick of this group.

All other stocks are Ranked B and C, mainly due to volatile EPS, with exception of newcomer **Resort Income Investors** and **Wedgestone Financial**. Rankings are based on EPS and dividend growth, balance sheet strength, and exposure to outside forces. For stable income, buy/holds are: **BRT**

## IN THIS ISSUE:

Realty, **Cenvill Investors**, and **Mellon Participating**; a more aggressive income buy would be **Lomas & Nettleton Mortgage** and **Resorts Income. Lomas Financial Corp.** is the quality recovery play.

Here's a summary of Ranks and Ranking changes, yield, and price/book ratio:

| | Rank | Yld. | Price/Book |
|---|---|---|---|
| Amer. Realty | C | 14.8% | -35% |
| BRT Realty | B | 13.1 | +31 |
| Cenvill Inv | B | 12.7 | +22 |
| Fed. Nat.Mtg. | A(+) | 1.6 | +113 |
| Integrated Res. | C | 0.0 | +10 |
| Lomas Fin. | B | 11.5 | +83 |
| Lomas &Net.Mtg. | B | 13.4 | -22 |
| Mellon Partic. | C | 11.3 | -12 |
| Resort Income | NR | 13.5 | -1 |
| Wedgestone Fin. | NR | 0.0 | -57 |
| TOTAL/AVG.... | | 9.2% | +12.6% |

Ranking Changes: + Up; - Down; NR-Not Ranked.

## Bush Capital Gains Plan Boost for Realty Stocks

President Bush has stirred a hornet's nest in Congress by making good on his campaign pledge to seek a reduction in the capital gains tax.

The plan could be a major boost for realty stocks — if Congress buys it. Early Congressional reaction clearly opposes the plan — but the battle is far from over.

Bush wants capital gains cut as low as 15% (vs. 33% max rate now) for non-depreciable assets: stocks and other securities, land, and similar items. Corporations could not get the lower gains rate. Initially the lowest 15% rate would go to assets held for one year, but this would stretch to three years down the road, a device intended to front-end load the tax benefits of a lower capital gains tax.

All depreciable assets — income property, art, antiques — would be excluded from the lower rates. And thereby hangs the potential kick for realty stocks:

Early analysis is that such a two-tier capital gains tax could create huge traffic in converting income property into securities qualifying for the lower gains tax. To be sure, tax writers already are thinking about ways to limit or eliminate this potential, but in tax matters, the private practitioners are generally one or two steps ahead of the tax writers.

At this stage, we don't know whether lowering capital gains will make it into law, since high-bracket taxpayers generally get the bulk of capital gains benefits. Certainly Congress will add some restrictions on converting income property into securities, even if it buys the Bush plan. The plan makes economic sense, since lower capital gains taxes historically seem to produce more revenue. We'll keep watching the proposal as Congress begins consideration.

## News of Realty Stocks:
### New Tender For General Development; Peter Bedford Turns up Heat on Wells Fargo Mtg.

Amruss, a Colorado limited partnership, wants to buy **General Development Corp.** (GDV: NYSE) for $18 cash plus $5 in a junk-bond style debenture. Amruss is a new player in the GDV picture and little is known about its sponsorship at press time. Previously, Metropolitan Consolidated Industries of New York City, a real estate and industrial company, talked about acquiring GDV but withdrew its offer.

GDV is a major Florida land developer and homebuilder with interests in timesharing, mortgage origination, and real estate brokerage. It returned to public markets in the breakup of City Investing Corp. in 1987. **We'd continue holding GDV**, which we still think is worth about $30/sh. ($23.45 book value plus about $7-$8/sh. value of utility plants in its Florida communities).

California Developer and Investor Peter Bedford is turning up the heat on **Wells Fargo Mtg. & Equity** (WFM: NYSE), the combination REIT in which he owns an 8% stake. WFM has been trying to sell its $175 mil. of equities for over a year now, and has been trying to complete a sale contract with privately held Koll Co. since last spring. But Koll has been unable to arrange financing, leading to several contract extensions.

Enough is enough, says Bedford. He let a standstill agreement with WFM expire January 20 and wants to start negotiating with WFM to buy its properties. WFM hasn't responded yet.

**We'd advise holding WFM until this story plays itself out.**

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AUDIT INVESTMENTS, INC., 136 SUMMIT AVENUE, MONTVALE, NJ 07645-1720 Phone (201) 358-2735
KENNETH D. CAMPBELL, PRESIDENT JOHN M. HIGGINS, EXEC. EDITOR FAYE KREISMAN, STATISTICS MICHAEL HOUSTON, ANALYST.

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## AMERICAN REALTY TRUST (ARB: NYSE)

ARB is a mortgage REIT caught in the trauma surrounding Southmark Corp. (SM: NYSE—RSR Jan.13 and Dec.23). SM, which owns 40% of ARB's shares, has offered ARB as a consolation prize — or sacrificial lamb — to persuade ousted former SM execs Gene Phillips and Bill Friedman to leave SM in relative peace. Friedman and Phillips already controlled 12% of ARB's stock and should wind up with about 22%.

Moves by Friedman and Phillips to consolidate control over ARB sparked a revolt among the REIT's ranks with five trust executives and two outside directors noisily resigning the past two weeks. Former ARB President Joseph Grosz and former Executive Vice President Larry Ettner tried to prod Friedman and Phillips into renouncing their penchant for the kind of insider dealing that made SM notorious. They quit after Friedman and Phillips rejected a proposed board resolution renouncing self-dealing, then moved to stack the board with allies.

**Gut Issue: What shape will ARB take after Friedman and Phillips gain complete control?** The two former SM execs already control the board with the addition of another former SM official as an "outside" director. On Feb. 8, ARB gave notice that it will terminate its advisory agreement with SM subsidiary American Realty Advisers in 60 days. We expect a new contract will be entered into with a Friedman-Phillips entity such as National Realty Advisers.

What then? First, we expect SM to return 5.5 mil. of its ARB shares to the trust. In exchange, we believe that ARB will release SM "keepwell" guarantees on $123 mil. in loans purchased from SM since 1987. Under the proposed transaction, which had not been finalized at press time, the commercial loans will be pooled with ARB taking a senior position and SM taking a junior position.

That means ARB will still be pretty well protected in the event of a default, while SM gets a $123 mil. contingent liability off its books. While ARB's per-share results should increase as a result of the reduction in outstanding stock, ARB will not be able to recover its money as rapidly if the loans go bad. In fact, the one point on which the two ARB factions agree is that extinguishing the "keepwell" agreement is positive for ARB's shareholders.

Despite the protests of the former ARB execs, related party transactions have been the soul of ARB recently and are responsible for its resurgence since 1986, when ARB was a disqualified REIT. While relying on SM for future transactions is pretty much out of the question, Friedman and Phillips have an extensive network of developers and other borrowers (including Syntek, their personal holding company) that will likely tap ARB.

We believe ARB will be an important vehicle for the pair's expansion. If that makes you nervous, don't sign up. But going along for the ride for the intermediate term could be a profitable trip because Phillips-Friedman are expected to use ARB as their main vehicle to try and rebuild investor confidence — and their empire.

Equity at Sept. 30, 1988 stood at $6.58/sh. At today's price, ARB common sells at a 35% discount to book value. Future payout rate is uncertain, because ARB's latest dividend included $0.15 regular distribution and $0.03 from revamping of its advisory contract. Whether that $0.03/sh. payout continues isn't certain. EPS seems to have settled at $0.60 annually.

**Advice: If you're nervous, sell ARB. If you are willing to wait for the situation to stablize, hold it. But don't buy until the dust settles.** We can't forecast with any precision what ARB will look like financially in 18 months. (JMH)

ARB—NYSE Rank C Dec. yrs. 21.73 mil. shs.

Price: $4.25 Div. $0.63 Yld. 14.8%

| Year | Op.EPS | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 9/85 | 0.18a | 0.00 | $8.25 | $6.25 | 0.0- 0.0% |
| 9/86 | 0.39a | 2.50 | 9.75 | 6.13 | NM— NM |
| 12/87 | 0.88a | 0.52b | 8.25 | 3.25 | 16.0- 6.3 |
| 1988E | 0.60 | 0.60 | 5.13 | 3.88 | 15.5-11.7 |
| 1989E | NE | 0.63 | | | |

a-Bef.cap.gains: $1.10 '85; $0.14 '86; $1.08 '87. b-Annualized.
Finances: Debt: $62.2 mil.; Equity: $143.0 mil. or $6.58/sh. Debt/equity ratio: 0.43-1.
Address: 15770 Dallas Pkwy., #1100, Dallas, TX 75248. (214) 233-0100.

## BRT REALTY TRUST (BRT: NYSE)

BRT has evolved from a small combination REIT into a short-term, senior and junior mortgage lender secured by income producing properties located in NY, NJ, CT and PA. BRT is under the guidance of principals of Gould Investors L.P. and about 16% of shares are owned by the Gould family.

But earnings and dividend growth per share have stalled recently, at $0.62/qtr. ($2.48 annually) in the last three reported quarters. Part of this stagnation traces to a higher number of shares outstanding from a March 1988 offering. This is because BRT must expand its capital base periodically, the most recent time being BRT's sale at $18.875/sh. of 1.64 mil. additional shares in Mar. 1988; the sale raised $28.5 mil. but boosted average shares outstanding by 37%.

Known for its market expertise, BRT's forte is in making quick lending decisions. For its fast action, BRT gets returns 1/2% to 1-1/2% over comparable lenders and 3-5% over prime rate. BRT has a high degree of sophistication in the markets in which it operates, manifest under its chief lending requirement: that it be comfortable running the property itself.

**Gut Issue: How will BRT grow its portfolio as interest rates continue their climb, and the default risk of lending increases?** With nearly 95% of its investments in variable rate mortgages, BRT is clearly going to have to tighten qualification

standards in a rising interest rate environment.

The growth issue arises, not from a lack of high yield investments or a squeeze on spreads, but from short-term investment maturities which must be rolled over into new loans. But as rates rise, default risk increases because developers can't pay the higher rates. Dividend payout depends on ability to make new investments and employ the existing capital base on an ongoing basis, forcing portfolio downsizing or assumption of higher risks.

Invested assets of $201 mil. at Dec. 1988 are 99% earning mortgages and 1% nonearning. Mortgages are 56% first mortgage loans, nearly all short-term; 44% junior mortgages, of which over half are secured by apartment projects; and 2% wraparound mortgages. Most loans secure properties in the New York metropolitan area, and are generally made as bridge or temporary financing for conversion or rehabilitation of apartments and more recently for office/retail financing. Terms are from 6 to 36 mon. BRT seeks to enhance yield by participating in gross revenues from conversion and selling participations in some loans. Nonearning loans have been well controlled.

BRT has no shortage of funds available to invest. Back in July 1987, BRT entered into an unsecured credit agreement for $150 mil., of which $75 mil. was available at below prime as short-term commercial paper. At Dec. 1, 1988, borrowings were $10.12 mil. bank-line and $75 mil. commercial paper.

**Advice: Buy/hold for income.** BRT has come up a big winner in the bridge-financing game by smart lending in markets its principals know well, but dividend support could shrink if BRT can't roll-over its money into credit-worthy investments. (MJH)

BRT—NYSE RANK B Sept. years 7.290 mil. shares.
Price: $18.88 Div. $2.48 Yld. 13.1%

| Year | Op.EPS | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 1985A | 1.26 | 0.00 | $ 9.38 | $5.25 | 0.0- 0.0 |
| 1986A | 1.75 | 0.40b | 17.25 | 7.13 | 22.4- 9.4 |
| 1987A | 2.33a | 1.99 | 20.13 | 14.50 | 14.1- 9.9 |
| 1988A | 2.53 | 2.48 | 19.25 | 14.50 | 17.2-13.0 |
| 1989E | 2.55 | 2.48 | 19.38 | 18.38 | 13.5-12.8z |

z-To date. a-Excl. 7c/ cap. gains. b-$1.60 annualized.
Finances: Debt: $82.2 mil. Equity: $105.3 mil. or $14.46/sh. Debt/Equity: 0.8 times.
Address: 60 Cutter Mill Rd., Great Neck, N.Y. 11021. (516) 466-3100.

## CENVILL INVESTORS INC. (CVI: NYSE)

CVI's portfolio consists of construction and development loans mainly secured by Southeast Fla. condo and apartment developments. About 21% of loans are to Cenvill Development (ASE), a related entity from which CVI was spun-off in 1981. CVI is increasingly lending in other parts of the state and for office and shopping center development.

**Gut Issue: Where will growth in CVI's portfolio come from in an overbuilt market?** CVI is finding it increasingly difficult to put money out. This has sent CVI into other Fla. markets and non-housing investments.

So far mining these new areas isn't reflected in higher invested assets. Invested assets of $195.3 mil. at Sept. 30 were down 4% from year-end 1987. During the Sept. quarter CVImade additional commitments of approx. $1 mil., bringing the level of 1988 commitments to $18 mil. and the unfunded commitment level for the nine months of 1988 to $46.7 mil.

Part of CVI's problem is that its biggest borrower, Cenvill Development, isn't borrowing as much anymore. In the Sept. quarter, Cenvill Development repaid $25 mil. under its revolving credit agreement, but only reborrowed $10 mil. Only other recent funding was acquisition of a $1.25 mil. short-term purchase money mortgage of a successful builder collateralized by lots at The Polo Club of Boca Raton.

CVI's earnings should be positively affected as interest rates increase — if it can increase funded investments — because a larger variable-rate investment component ($121.7 mil.) benefits and outweighs any effective increases in its cost of debt as the portfolio's $44 mil. fixed (13.35% average rate) component loses its advantage over new funds.

Equity sizzle: CVI's kicker is its small equity portfolio consisting of two shopping centers and some smaller properties, considerably undervalued at $5.5 mil. book. CVI is expanding the center in West Palm Beach from 164,000 sq. ft. to 241,000 sq. ft. (47%) at a cost of $5-6 mil. and is upgrading rents substantially. The other center in Deerfield is 95% leased.

Earnings outlook: EPS should be about $2.20 in 1988 and $2.00 in 1989 (before land sales). Nine month 1988 EPS is off approx. 1.4% against comparable earnings in the 1987 period, excluding a $0.21/sh. property sale gain and a $0.05/sh. provision for loan losses and write-offs (net gains of $0.16/sh.) in 1988 as compared to $0.10 per share sale gain in last year's period.

Dividends: CVI recently cut payout 9% to $2.00 annual rate and believes it can hold that rate. Payout was hurt by a problematic investment, for which CVI projected quarterly loss of $0.045 per share due to non-accrual of interest on two mortgages on Boca Grove Plantation in Boca Raton. The project went into default on Oct. 1, 1988, as CVI's $14 mil. loan to the developer was not repaid at maturity and legal action to recover the funds has begun.

Investments at Sept. 30, 1988 were: 85% real estate mortgage notes including senior loans to CDC; 2% subordinated CDC notes; 10% GNMA certificates; and 3% property, mainly shopping centers. CVI plans renovating the center to boost rents after

winning a favorable verdict against a former tenant

**Advice: Hold for income.** CVI operates in the highly competitive south Florida realty development and condo market, where its managers have long operated successfully. Earnings are positively impacted by slight interest rate increases. Officers of CVI hold about 20% of common shares. (MJH)

CVI—NYSE RANK B Dec. years 6.88 mil. shares.
Price: $15.75 Div. $2.00 Yield 12.7%

| Year | Op.EPS | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 1985A | 2.12a | 2.35 | 23.00 | 15.38 | 15.3-10.2 |
| 1986A | 2.07 | 2.00 | 20.00 | 15.63 | 12.8-10.0 |
| 1987A | 2.20a | 2.15 | 21.88 | 16.25 | 13.2- 9.8 |
| 1988E | 2.20a | 2.15 | 20.38 | 17.13 | 12.8-10.8 |
| 1989E | 2.00 | 2.00 | 16.00 | 15.13 | 13.2-12.5z |

5 Yr.Grwth.-1.4% -4.0% z-To date.
a-Incl. amortized & curent sale gains: '85 $0.04; '87 $0.10; '88 $0.21.

Finances: Debt: $89.7 mil. Equity: $90.2 mil. or $12.87/sh. Debt/Equity: 0.99 times.
Address: Century Vil. Admin. Bldg., N. Haverhill Rd., W. Palm Beach, Fla. 33417. (305) 686-2577.

# FEDERAL NATIONAL MTG. ASSN. (FNM: NYSE)

FNM, the Federally chartered but stockholder owned company that provides liquidity to the national secondary mortgage market, has made a spectacular recovery from the dark high-interest days of the early 1980s when FNM reported nothing but red ink. FNM's EPS rebound has boomed its stock: up 66% in 1988 and another 17% since New Year's Day. We are boosting Rank to A.

**Gut Issue: Can FNM sustain its run of good earnings?** FNM insists that the days are gone when FNM earnings reflect the money market's short-term fever chart. Many investors aren't quite so sure, and still play the stock like a money-market instrument. FNM Pres. David Maxwell is so confident of FNM's new insulation against money market tides that he predicts a new 1989 EPS record under "reasonably foreseeable events" — i.e., no more than 2% interest swing from today's levels. We figure that FNM could earn $7.25-$7.50 for 1989, because it now has four profit components:

Portfolio growth: FNM buys mortgages from local originators and holds most of them. FNM's portfolio grew 6.5% to $103 bil. in 1988, about in line with its historic 6% growth rate. That growth outpaces inflation by about 2%-3%. FNM in recent years has tried to boost portfolio yield by increasing holdings of adjustable rate mortgages (ARMs), now at 20.4%, and shortening portfolio maturity (about 20-25% of loans mature in less than 20 years). This has boosted overall portfolio yield to 9.84%.

Rising spread: FNM finances mortgage purchases by selling "agency status" securities. In 1988 FNM widened its net spread on mortgages by 0.20% to 0.61% by rolling over high-cost debt from the early 1980s with current cost debt. This widening spread has helped fuel the EPS turnaround. But this high leverage (non-convertible debt is 20 times capital) makes FNM a barometer of money market trends.

Higher MBS fees: FNM has become a major issuer and guarantor of mortgage backed securities (MBS), earning fees that largely fall to the bottom line. It issued $54.9 bil. MBS in 1988 and had $178.2 bil. MBS outstanding at year end. MBS fee income rose 25% to $328 mil. in 1988, and should come close to $400 mil. this year.

Lower credit losses: This should be the big kicker in FNM's future as loan loss provisions fall from present high levels. FNM provided $365 mil. in 1988 for loan losses, or about $4.64/sh. pretax and little changed from 1987. But realized losses are starting to fall already as tighter underwriting standards put into effect in 1985 take hold. Sooner or later, EPS will benefit.

**Advice: Buy these volatile shares on any dip to the mid-50s** (about 8 times our 1989 estimate) and hold long-term. (KDC)

FNM—NYSE Rank A Dec. yrs. 78.66 mil. shs.
Price: $61.25 Div. $0.96 Yld. 1.6%

| Year | Op.EPS(Dil.) | Div. | High | Low | P/E Range |
|---|---|---|---|---|---|
| 1985 | (0.10) | 0.16 | $29.63 | $14.00 | NA |
| 1986 | 1.42 | 0.20 | 42.00 | 22.75 | 29.6-16.0 |
| 1987 | 4.63 | 0.36 | 48.38 | 25.00 | 10.4- 5.4 |
| 1988 | 6.32 | 0.72 | 52.63 | 29.00 | 8.3- 4.6 |
| 1989E | 7.25 | 0.96 | | | |

Debt: $106.0 bil.; Capital: equity: $2.26 bil. Plus $2.3 bil. debentures; Capital ratio: 20:1. Equity/sh.: $28.73.
Address: 3900 Wisconsin Ave. N.W., Washington, D.C. 20016. (202) 537-7115.

# INTEGRATED RESOURCES INC. (IRE: NYSE)

Once king of tax-shelter syndicators, IRE has totally revamped product line and income stream. EPS however remain highly leveraged, cash flow remains negative, and the founding Zises brothers have sold out and agreed to sell control to an insurance company. All this makes shares volatile and speculative. Rank remains at C.

**Gut issue: Does the pending stock sale signal troubles ahead?** The Zises brothers have sold most of their 900,000 sh. block (12.0%) to I.C.H. Corp. (ICH: ASE—$4.88), Louisville insurance holding company, at $21 — or 50% over today's market. ICH also agreed to buy 7.5 mil. new shs., also at $21, giving it control. Understandably, several shareholders have sued.

Beyond the suits, the sale attempt may tell investors volumes about how IRE's principals see IRE's future. For the sale is eerily reminiscent of Southmark Corp.'s tumble. ICH was the buyer in the wings when Southmark Corp. officers first spotted cash flow trouble in Nov. 1987 and quickly won an agreement to merge ICH and SM. That deal fell apart but it signalled that SM's top officers could no longer rely upon Wall Street for its financing needs. SM cash flow has since dried up and the stock dived below $2/sh.

What worries us is that IRE has been running cash flow negative by design. Our previous reviews over the years have repeatedly focused upon IRE's negative cash flow stance. IRE always argued that it needed front-end cash to inventory properties and mount sales efforts for its tax shelter and annuity programs. When it entered mutual funds, it agreed to pay front-end brokerage commissions so sales were "no load" to investors. Positive cash flow would indicate no-growth and decline, IRE said.

Like Southmark, IRE relied heavily upon junk bond financing from Drexel Burnham Lambert, the Wall Street junk powerhouse that faces a tough future because it has decided to plead guilty to securities law violations. Whether Drexel can continue to raise all the cash needed by big customers like IRE is an unknown. Faced with this uncertainty, the Zises brothers opted to sell out.

**Advice: Avoid or sell.** IRE stock will rise or fall short-term based on the ICH transaction, not underlying business operations. Faced with these multiple uncertainties, IRE is suitable only for nimble traders. (KDC)

IRE—NYSE Rank C Dec. yrs. 7.53 mil. shs.
Price: $13.88 Div. $0.00 Yld. 0.0%

| Year | Op.EPS(Dil.) | Div. | High | Low | P/E Range |
|---|---|---|---|---|---|
| 1984A | 3.22 | 0.00 | 29.50 | 11.88 | 9.2-3.7 |
| 198 | 3.17a | 0.00 | 26.38 | 13.75 | 8.3-4.3 |
| 1986 | 1.06a | 0.00 | 40.25 | 16.25 | 38.0-15.3 |
| 1987 | 2.98a | 0.00 | 32.88 | 14.75 | 11.0- 4.9 |
| 1988E | 3.00 | 0.00 | 23.75 | 11.75 | 7.9- 3.9 |
| 1989E | NE | None | | | |

a-Before losses on extra items: '85 $1.13; '86 $2.79; '87 $0.25.

Finances: Debt: $905 mil.; Pfd.: $350.7 mil; Common: $180.25 mil. incl. $84.9 mil. intangibles. Tangible book value: $12.64/sh.
Address: 666 Third Ave., New York, N.Y. 10017. (212) 551-6000.

## LOMAS FINANCIAL CORP. (LFC: NYSE)

LFC, the nation's largest independent mortgage banker, has diversified rapidly into related financial services, and less than 25% of 1989 income will come from mortgage banking. Still, problems from mortgage banking and related real estate development led to big 1988 writeoffs and continue to erode overall profit.

**Gut issue 1: Is the certainty of LFC's recovery more important than its pace?** LFC is starting the road back from a disastrous June 1988 fiscal year, when huge reserves plunged it $1.85/sh. into the red, first loss in LFC's history. Immediately after its profit debacle, Wall Street looked eagerly for LFC to resume its 15%-plus annual growth rate and expected about $1.40/sh. for fiscal 1989.

With half that year reported and an econiomic environment forboding, most analysts are scaling estimates back and pushing the recovery further into the future. A good number of analysts feel blindsided by LFC's rosy projections of growth at the beginning of FY 1988, only to see those hopes dashed. Credibility, once lost, is difficult to regain, and impatient analysts seek a rapid rebound.

But does it really matter. The big picture is that LFC now has a more diversified earnings base, with operating earnings divided about 13% mortgage banking, 23% leasing; 23.5% retail banking, 14% life insurance, 17% short-term lending, and (8%) realty development. But LFC earned $0.43 in the half-year to Dec., better than the year-ago loss, altho only $0.14 came from operations, the rest from debt retirement and special items. We think $1.25 is more likely from all sources for 1989. Hence—

**Gut issue 2: Can the dividend hold?** LFC still clings to a $1.40 payout and says it will hold there thru FY 1989 —or less than two quarters away. At current price LFC yields 11% — maybe too nice. We'd expect a downtick unless EPS turns around big soon.

**Advice: We'd continue to be a holder and buyer here**; sour grapes from Wall Street don't obscure the fact that LFC has an excellent record of planning its business to reduce volatility and wisely expanded into new areas. Unrest in mortgage banking should end reasonably soon. (KDC)

LFC—NYSE Rank B June years 38.53 mil. shs.
Price: $12.13 Div. $1.40 Yld. 11.5%

| Year | EPSdil. | Div. | High | Low | P/E Range |
|---|---|---|---|---|---|
| 1985 | 1.61 | 0.81 | 24.42 | 14.92 | 15.2-9.3 |
| 1986 | 1.83 | 0.97 | 35.33 | 20.67 | 19.3-11.3 |
| 1987 | 1.45 | 1.26 | 39.25 | 23.25 | 27.1-16.0 |
| 1988 | d1.85 | 1.40 | 34.50 | 15.00 | d |
| 1989E | 1.25 | 1.00 | 20.38 | 11.75 | 16.3-9.4z |

z-To date.

Finances: Debt: $2.2 bil.; Equity: $506 mil.; Debt/equity ratio: 4.4-1. Equity is $6.63/sh.
Address: 2001 Bryan Tower, P.O. Box 655644, Dallas, TX 75265. (214) 746-7111.

## LOMAS & NETTLETON MTG. INVESTORS (LOM: NYSE)

LOM is the oldest pure short-term mortgage REIT, managed by Lomas Financial Corp. LOM has compiled an excellent record of maintaining dividends and liquidity. But current EPS and payout are being squeezed by rising short-term interest rates at current leverage ratios. We hold Rank at B.

**Gut issue: Can LOM reverse its EPS dip in two-four quarters?** The much bally-hooed inverted yield curve (i.e., shorter-term rates higher than longer-term rates) is pinching LOM. With about 75%-80% of loans tied to the prime rate, LOM should be insulated against rising rates. But the freakish market has seen commercial paper rates run up without any corresponding boost in prime, squeezing LOM's net spread on borrowings to about 2.45% in Dec., down 0.55% since Sept.

With $535 mil. in floating rate debt, the narrowing spread dropped EPS to $0.60/sh. in the Dec. qtr., down 6.2% from year-ago and 3% from the Sept. qtr. We now see a further dip to about $0.58-59 in the Mar. and June qtrs. before EPS starts turning upward again. LOM pays substantially all EPS as dividends.

Practically speaking, LOM has about reached the limits of leverage. LOM's $890 mil. debt is 3.3 times $267.9 mil. shareholders' equity, about the limit of leverage experienced by short-term construction/development lending REITs during the mid-1970s. Higher leverage ratios tend to produce more interest rate risk than the very small increment to earnings.

So far LOM has escaped harm from high levels of non-earning loans. Non-earning investments fell to $66.6 mil. or 5.8% of investments at Dec. 31, down from 6.4% nonearning in Sept. Once concentrated in Texas, LOM has escaped troubles by diversifying loan holdings into other states. California now accounts for about 28% of $1.15 bil. outstanding loans, with Texas in fourth place.

Loans average 15 mon. terms and are about 66% construction first mortgages, 24% acquisition/development firsts, and the rest other loans.

**Advice: At a 22% discount to book value, LOM is a higher yielding recovery stock for aggressive risk accounts.** (KDC)

LOM—NYSE Rank B June yrs. 11.70 mil. shs.
Price: $17.88 Div.: $2.40 rate Yld: 13.4%

| Year | EPS dil. | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 1985 | $2.49a | 2.45 | $28.63 | $16.88 | 14.5-8.6% |
| 1986 | 2.61a | 2.69 | 34.00 | 24.00 | 11.2-7.9 |
| 1987 | 2.42a | 2.49 | 32.38 | 22.13 | 11.3-7.7 |
| 1988 | 2.54a | 2.54 | 23.75 | 16.25 | 15.6-10.7 |
| 1989E | 2.40 | 2.40 | 23.38 | 17.50z | 13.7-10.3z |

a-Fully diluted. z-To date.

Finances: Debt: $890 mil.; equity: $267.9 mil. or $22.89/sh. Debt/equity ratio: 3.3-1.
Address: 2001 Bryan Tower, P.O. Box 655644, Dallas, TX 75265. (214)746-7111.

## MELLON PARTICIPATING MORTGAGE TRUST (MPMTS: OTC)

Formed in 1985 with an expected 10-year life, this finite-life mortgage REIT is now in the last year before it must cease making new investments. MPMTS invests in participating, shared appreciation, convertible and fixed-rate mortgages and joint ventures across the country. Shares hold Rank C.

**Gut issue: The impending onset of MPMTS' liquidation period provides investor opportunity.** When it went public in Feb. 1985, MPMTS promised investors that it would start giving them their money back beginning Jan. 1, 1990. MPMTS has no loans scheduled to mature this year, except for one fixed-rate loan which possibly could be repaid during an option period when the interest rate falls from 15.1% to 12.25% this month.

After 1989, investors must look toward maturity of current loans to receive any capital payouts. All existing loans have 1995 and 1996 stated maturities, but it's always possible that early payoffs might occur, especially should interest rates fall sharply from the 9.5% to 11.875% stated loan rates (e.g., one such loan was prepaid in Mar. 1988). MPMTS also shares in additional property revenues and/or increases in underlying property values at maturity.

Invested assets at Sept. 1988 totaled $70.3 mil. including:

$14 mil. joint venture investment owning 24 Pier 1 Import stores. The venture, the most recent for MPMTS, may buy 35-50 Pier 1 stores ultimately and net lease them to Pier 1. MPMTS gets 9.75% plus overage rents and longer-term participations until a cumulative 12% return is reached.

Total $42.1 mil. in five participating mortgage loans including: $20 mil. on six Carson Pirie Scott department stores near Chicago; and shopping centers in Arbutus, Md. and Ramapo, N.Y., $8.55 mil.; office/warehouse in Atlanta, $3.1 mil.; and a Brooklyn manufacturing plant, $10.5 mil. All are running full except 75,000 sq.ft. Peachtree Business Center (Atlanta), on which MPMTS recognized a $0.02/sh. loss in Sept. 1988.

Total $14.25 mil. in one fixed-rate loan whose interest has just stepped down from 15.1% to 12.25%, on a Hawthorne, CA R&D/office.

<u>Dividends</u>: To meet new IRS regs, MPMTS pays quarterly plus a year-end clean-up dividend to equal full-year EPS.

**Advice: Shares are long-term income buys.** (KDC)

MPMTS—OTC Rank C Dec. years 8.65 mil. shs.
Price: $7.50 Div. $0.834 Yld.: 11.1%

| Year | EPS | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 1985 | $0.83a | $0.8675a | $10.50 | $8.50 | 10.2-8.3% |
| 1986 | 1.03 | 1.07 | 11.63 | 8.75 | 12.2-9.2 |
| 1987 | 0.88 | 0.937 | 12.00 | 6.50 | 14.4-7.8 |
| 1988E | 0.84 | 0.834 | 8.13 | 7.13 | 11.7-10.3 |
| 1989E | 0.84 | 0.84 | | | |

a-For period from 2/13 to 12/31/85.

Finances: Debt: None. Equity: $79.2 mil. or $9.16/sh.
Address: 551 Madison Avenue, New York, NY 10022. Phone: (212) 702-4040.

## RESORT INCOME INVESTORS (RII-ASE)

RII is a mortgage REIT that came public Oct. 24, 1988 to help finance the development of three resorts in Hawaii, California and the Caribbean. The properties are being developed by prominent Hawaiian hotel developer Chris Hemmeter, friend of former presidents and builder of seven Hawaiian hotels. One of the few REITs to make it out the underwriters' door last year, RII netted $39.6 mil. selling 3.6 mil. shares at $12.50 each.

**Gut Issue: RII's price decline has pushed the dividend yield to tempting 13.4%.** Since the offering, RII's shares have dropped to $11.13 on a $1.50 annual dividend. Although RII's cash flow falls short of the payout level, the dividend is guaranteed by Hemmeter affiliates through October 1991. That guarantee and a default guarantee extends to Hemmeter's personal holdings, so mid-term weakness in the dividend is not a big concern.

However, the structure of the loan portfolio presents potential future problems. RII's mortgage portfolio is composed of five loans on pending Hemmeter projects:

Hemmeter Resort at Laguna Niguel: Three second mortgages totalling $18 mil. at an interest rate of prime plus 4 points. The loan is secured by 175 acres of oceanfront property in Orange County, Calif. Hemmeter has cleared zoning hurdles for two

hotels with a total of 1,126 rooms, 13 restaurants and bars and a beach club. Construction is scheduled to begin April 1. The three loans mature March 1991.

Kuai Lagoons Resort: An $11 mil. pre-development loan on Phase III of the Hawaiian resort. Hemmeter plans to use the money to build two golf courses and 70,000 square feet of retail space to accompany an 847-room Westin Hotel built earlier. The loan carries an interest rate of prime plus 3 points and is collateralized by Hemmeter's 50% interest in the resort. The loan matures in March 1990.

St. Maarten Resort: A $7.75 mil. second mortgage on a 28-acre site on the Netherlands Antilles island. Hemmeter plans to build a 510-acre resort hotel including seven restaurants and bars and assorted leisure facilities. The loan carries an interest rate of prime plus 4 points and matures in March 1990.

Of the $39 mil. package, $10 mil., or 25%, was held back as an interest reserve and 2 points (2%) were retained. The interest rate is adjusted monthly, so RII's income will be quite rate sensitive. The borrower has the option of renewing some or all of the five loans for up to two years, an option that calls for a participation kicker of a small percentage of the development properties' appreciation.

Our question is whether Hemmeter will decide to renew the loans and their hefty interest rate. He has said that he created RII to have a publicly-held financing vehicle for unspecified future deals. Every developer, it seems, wants to have his own REIT and Hemmeter is certainly big enough to make use of one. Since Hemmeter and his affiliates are on the hook for dividend support through October 1991, it is likely he will renew. But after that guarantee expires shareholders could be on their own for both dividends and loan production. Hemmeter was willing to pay high rates to get RII sold initially, but it will be a different ballgame when the REIT has the burden of placing its money.

It would be tough for RII to replace the loans and still support the dividend. RII is currently earning a blended rate of 3.7% above prime on its money. We see no evidence that the adviser has the skills to aggressively lend beyond the Hemmeter affiliates.

**Advice: Buy for speculative yield, but plan to hold for no more than two years.** If Hemmeter doesn't renew the loans due in 1990, we predict RII's share price will drop despite the dividend guarantee. At this time we feel the danger is slight. But whether RII can sustain the dividend after the guarantee disappears — particularly if rates are softer — is a different issue. RII is a stock only for investors willing to monitor the REIT closely.(JMH).

RII—ASE No Rank Dec. years 3.6 mil. shares
Price: $11.13 Div.: $1.50 Yield:13.4%

| Year | Op.EPS | Div. | High | Low | Yield range |
|---|---|---|---|---|---|
| 1988E | $0.25 | $1.50 | $13.25 | $11.13 | 11-13% |
| 1989E | 1.45 | 1.50 | | | |

Address: 190 LaSalle St. Chicago, IL 60603 (312) 444-1400
Finances: Debt of $50.0 mil.; Equity: $46.6 mil. or $8.05/sh. Debt/equity ratio: 1.07-1

## WEDGESTONE FINANCIAL (WDG: NYSE)

An aggressive Boston-based short-term lender, WDG has encountered problems recently as nonearning assets rose and the dividend was omitted to reflect reduced EPS and cash flow.

**Gut Issue: How long will it take WDG to turn its portfolio around and shed festering problem properties?** When we first asked this question last Sept., we thought WDG might make a short and sharp U-turn. Now it appears EDG's problems are being exacerbated by widening real estate softness in New England and holders may sit some time without a dividend.

WDG's problems start with its aggressive lending style: Loans are priced at 6% over prime and 6% commitment fee; with such rates, WDG wants only borrowers who have been turned down elsewhere but have a need for quick funds to close a real estate deal. The formula produces high profits if, as expected, a good many borrowers are able to refinance quickly and repay WDG, giving it a quick 6 points on its money. WDG copes with an expectably higher level of problems by obtaining multiple collateral on loans (often it lends only 50% of value of this combined collateral), aggressive marketing of problem properties, and low debt.

Now problem assets have soared: 35% of $100.8 mil. investments were nonearning loans or foreclosures at Sept. 30, and another 10.7% were partially earning loans. While Dec. 31 numbers aren't final yet, our discussion with management indicates very little net change to date. The problem is that tough state foreclosure laws are preventing WDG from taking control of collateral in many instances.

A status look at six large loans totaling $34.3 mil. indicates how slow recovery is now likely to be: (a) $4.0 mil. foreclosure of a Plant City, Fla. motel is a second behind $6.3 mil. first on a 280-room motel said to be too large for its location; (b) $8.2 mil. partially earning loan on a Kansas City office now 63% leased; (c) $4.65 mil. junior mortgage on Foxboro, MA land where the borrower filed Ch. XI and WDG is working out a partial sale in bankruptcy court; (d) $4.2 mil. on 80 acres at Candlewood Lake, CT, stalled by tough state foreclosure laws; (e) $6.3 mil. on land in Queens, N.Y. in foreclosure; (f) $3.3 mil. first mortgage on a city block in south Philadelphia, also in tortuous foreclosure process; (g) $3.65 mil. on a 50-slip marina in Port Salerno, Fla., stalled in foreclosure.

**Advice: Avoid for now.** Our sense is that WDG's problems will take a long time to cure. (KDC)

WDG—NYSE Rank: None Dec. yrs. 5.80 mil. shs.
Price: $3.50 Div.: None Yld. None

| Yr. | Op.EPS | Div. | High | Low | Yld.Range |
|---|---|---|---|---|---|
| 1985 | $1.35 | 1.19 | $10.00 | $7.38 | 11.9-16 |
| 1986 | 1.78 | 1.54 | 17.13 | 9.25 | 9.0-17 |
| 1987 | 1.79 | 1.79 | 17.25 | 10.50 | 10.4-17 |
| 1988E | d | 1.15 | 14.13 | 2.13 | 8.5-17z |

Debt: $50 mil. Equity: $46.6 mil. or &8.05/sh. Debt/Equity 1.07-1
Address: 181 Wells Ave., Newton Mass. 02159 (617) 965-8330